> affirmative steps to achieve economies of scale and any other savings they can. While one can assert that these utilities should strive to achieve such savings without any incentives, it is unlikely they will do so, or take the substantial step of merging without sharing in the benefits, and the incentive addresses this.

1999 N.Y. PUC LEXIS 109, at *26. The New York Commission further added that it was not reasonable to limit the sharing arrangement to three years, since it will take a substantial amount of time and effort for the companies to achieve all of the savings they have forecast. *Id.* at *27. Therefore, the Commission stated, in as much as the savings are expected to continue for five to ten years, "it was proper to allow shareholders to retain a portion of the savings during the initial five years", provided rate increases can be avoided. *Id.* Furthermore, the Commission concluded that the public interest was protected. *Id.*

The Nevada Commission approved a savings sharing approach in *Nevada Power Company, Sierra Pacific Power Company, and Sierra Pacific Resources*, Docket No. 98-7023, 1999 WL 135117 (Nev. PSC, Jan. 4, 1999). In that case the Nevada Commission established a procedure that affords the shareholders a reasonable opportunity to recover certain costs (including "premium-related costs") based on savings resulting from the merger. 1999 WL 135117, at *24-26. The Nevada Commission found that a credit for merger savings should be used to recover merger-related costs. *Id.* at *25. The commission explained that "[t]ransition costs, transaction costs and goodwill costs, after being properly assigned or allocated to non-competitive services, will be deemed eligible for recovery from ratepayers upon a showing that the level of such costs was prudent and that merger savings are sufficient to cover such costs." *Id.* The Nevada Commission found that "this treatment of the costs to achieve the merger provides a real hold harmless protection to ratepayers and effectively places a portion of the risks associated with the merger on the Joint Applicants." *Id.* at 26. This provides applicants a fair opportunity to recover merger costs through savings while truly holding ratepayers harmless. *Id.*

Numerous other state regulatory commissions have followed the trend and joined Massachusetts, New York, and Nevada, by recognizing that allocation of savings to shareholders provides an incentive for consolidations. Such regulatory commissions include The District of Columbia, Louisiana, Kansas, California, Kentucky, Connecticut, and Idaho. *See Baltimore Gas and Electric Company*, 180 PUR 4th 393, 419 (D.C. PSC, Oct. 20, 1997) (stating that a 75/25 sharing of savings is reasonable to shareholders and ratepayers and explaining that "[a] savings split that is lower than 100% is necessary to provide an incentive for the merger to be completed, so that a steady stream of savings can be achieved over many years that will be of benefit to [the] ratepayers."); *Entergy Corporation*, 146 PUR 4th 292, 330 (La. PSC, May 3, 1993) (stating that a 60/40 savings sharing proposal is a reasonable and well-balanced plan to share the expected merger savings, and explaining that "[i]t permits ratepayers to benefit from all the fuel savings flowing from the merger except those that come at the expense of [ ] other ratepayers. The plan to allow shareholders to keep 60% of O &M cost savings allows them a reasonable opportunity to recover the premium included in their investment . . . without which there would be no merger savings." The ratepayers also receive benefits through the plan by providing for annual review that will flow through their share of any savings); *Southwestern Electric Power Co.*, Docket No. U-23327, 1999 La. PUC LEXIS 141 (La. PSC, Sept. 16, 1999)(approving savings sharing plan); *Western Resources, Inc.*, 197 PUR 4th 175 (Kan. SCC, Sept. 28, 1999) (permitting sharing of merger-related savings between the utility company and its customers, and stating that "the Commission has balanced a myriad of conflicting factors, including the expectations of investors, uncertainties in a rapidly changing electric marketplace, and fairness to present and future ratepayers."); *UtiliCorp United Inc.*, Docket 99-WPEE-818 RTS, 198 PUR 4th 397 (Kan. SCC, Jan. 19, 2000) (recognizing that applicants should be allowed to recover the acquisition premium through cost of service requirements only to the extent that there are demonstrated savings created by the acquisition); *Louisville Gas and Electric Co.*, 180 PUR 4th 476 (Ky PSC, Sept. 12, 1997) (Kentucky Commission allowing a savings sharing plan); *Northeast Utilities*, 131 PUR 4th 357 (Conn. DPUC, March 31, 1992) (allowance of a savings sharing plan); *Washington Water Power Co.*, 164 PUR 4th 270 (Idaho PUC, Sept. 19, 1995); *Kernville Domestic Water Company*, No. 00-08-001, 2000 Cal. PUC LEXIS 566 (Cal. PUC, Aug. 3, 2000) (California Commission recognized the need to provide an incentive for acquisition of a small utility by allowing the creation of a deferred account for the recording of extraordinary expenses).

As the commissions in these and many similar cases have recognized, absent rate-making treatment of the nature proposed herein, the shareholders of the acquiring utility would have a disincentive to making acquisitions which are in the public interest. These commissions recognize that the ratemaking approach proposed by IAWC provides an appropriate incentive for acquisitions which benefit customers by providing for a recovery of, and opportunity for a fair return on, the investment in the acquisition which generates the benefits for the ratepayers.

In the present case, undisputed evidence shows that the purchase price for the Utility Assets was developed through extensive arm's-length negotiations. The evidence shows that the purchase price is the fair market value of the assets and, indeed, that there would be no Acquisition unless IAWC were willing to pay it. [IAWC Ex. 1.0, p. 9; Ex. 4.0, pp. 3-4.] Extensive data was also presented by Mr. Bobba of Merrill Lynch showing that the market price of utility assets can reasonably be expected, under present market conditions, to exceed book value (at multiples substantially higher than that involved here). [IAWC Ex. 6.0, pp. 2-4.] It is also undisputed that the Acquisition will not harm customers in IAWC's existing area and will benefit customers in the area served by CUCI as a result of (i) actions to be taken by IAWC to improve facilities, operations and service; and (ii) increased efficiencies as measured by the projected savings. [IAWC Ex. 1.0, pp. 9-10.] Thus, as the evidence shows, the Reorganization is precisely the type of reorganization which the Commission should encourage. [IAWC Ex. 1.0R, p. 3.] Under Staff's approach, however, the shareholder would be required to absorb the entire cost of the Acquisition Adjustment. [IAWC Ex. 1.0R, pp. 6-7.] As a result, Staff's proposal creates a disincentive to reorganizations, such as this one, which produce substantial savings and other customer benefits. [*Id.*]

IAWC proposes to limit the level of revenue requirement sought to cover the Acquisition Adjustment in any future rate case to ninety percent (90%) of Demonstrated Savings for the rate case test year. In light of this commitment, IAWC's ratemaking proposal cannot have an adverse impact on rates at any time, and will, as is undisputed, reduce the revenue requirement from the level which would otherwise exist over the forty-year period following the Acquisition.

**c. Illinois Law and Precedent**

The courts have previously been faced with arguments similar to those offered by Staff and IIWC in this case offering various technical justifications to force an Illinois utility to suffer the fate of bearing costs prudently incurred to generate savings for ratepayers, while passing the gross savings on to the ratepayers. As will be discussed, the courts have invariably seen through such efforts and ordered that the utility must be reimbursed for prudently-incurred costs expended to generate the savings and that only the net savings can be passed on to ratepayers.

The legal requirement that utilities be permitted to recover prudently incurred costs which benefit customers either directly or indirectly applies no less to acquisition-related costs than it does to other costs. In *United Cities Gas Co. v. Illinois Commerce Commission*, 225 Ill. App. 3d 771, 783, 587 N.E.2d 581 (4th Dist. 1992), the Illinois Appellate Court overturned a rate order in which the Commission disallowed recovery by United Cities Gas Company ("United Cities") of the costs of a "consulting and noncompete agreement" entered into by United Cities in connection with its acquisition of Union Gas Company, noting that the evidence in that case showed that "[t]he entire acquisition transaction, which encompassed the consulting and noncompete agreement as one of its integral parts, resulted in significant cost savings to United Cities' Illinois ratepayers." *Id.* at 777-78. The Court, therefore, reversed the Commission's decision to disallow recovery of the cost of the agreement, holding that "the amount which United Cities expended to secure this agreement is a legitimately incurred cost of service which it is entitled to recover in its rates." *Id.* at 778. The court also stated that, since the acquisition costs will result in "significant cost savings to United Cities' Illinois ratepayers" they are, therefore, also "legitimately incurred costs of service." *Id.* As the decision in *United Cities* indicates, the fact that costs are incurred in connection with an acquisition which will produce substantial benefits for Illinois-American's customers supports the allowance, not the disallowance, of such costs.

Also, in *Archer-Daniels-Midland Co. v. Illinois Commerce Commission*, 184 Ill. 2d 391, 704 N.E. 2d 387 (1998), the utility, in order to reduce the cost of fuel to its customers, incurred costs of (i) a $70 million payment to a coal supplier in order to buy out of an uneconomic coal supply contract, and (ii) associated carrying costs. Before the Commission, Staff argued that these costs would have to be borne by the Company because only costs of fuel could be passed through the fuel adjustment clause and these were costs for not receiving fuel. *Archer-Daniels-Midland Co.*, 184 Ill. 2d at 395. The Commission ruled in favor of the Company, but, the intervenors appealed. The Supreme Court stated that the utility would have been free to leave the existing uneconomic coal supply contract unaltered, but that the utility had engaged in "prudent purchasing" practices by monitoring its contract and seeking to change it when it became disadvantageous to its customers. *Id.* at 399. The Court held that this is precisely the type of prudent practice which ought to be encouraged and that disallowing the flow-through to ratepayers of the buy out payment and associated carrying costs would create a disincentive for utilities to engage in prudent purchasing practices. *Id.* at 400. *Archer Daniels-Midland* is directly analogous to the situation in the instant case, even to the extent of Staff's adoption of a "just say no" attitude.

In another case involving the recovery of costs incurred to generate savings, *Central Illinois Public Service Co. v. Federal Energy Regulatory Commission*, 941 F.2d 622 (7th Cir. 1991), the utility incurred substantial expenses in prosecuting certain litigation which resulted in a $25 million settlement in favor of the utility. The Federal Energy Regulatory Commission ("FERC") ruled that the utility could not recover its litigation expenses before distributing the settlement proceeds to ratepayers. *Id.* at 630. The court indicated that FERC somehow believed that, by deducting its litigation expenses prior to distributing the proceeds, the utility was attempting "to recover such costs through the fuel adjustment clause," whereas, without a special FERC variance, only fuel costs are eligible to be passed through the fuel adjustment clause. *Id.* The court held that the company had done nothing of the sort, but had merely sought to recoup the expenses it reasonably incurred in the prosecution of the seven-year litigation. The court explicitly recognized that, if the utility were unable to recoup its litigation expenses, then an "'inequity remains of requiring the shareholders to bear the burden of expenses to obtain a refund benefitting the customers of [the utility].'" *Id.* (quoting *Minnesota Power & Light Co. v. FERC*, 852 F. 2d 1070, 1073 (8th Cir. 1988).) "'Equity dictates that the charges of litigation leading to the recovery of [the settlement] proceeds should be deducted from those proceeds accruing to the beneficiaries.'" *Id.* (quoting *Central Illinois Public Service Co.*, 40 FERC at ¶65,120 (1987)).

One of the more troubling aspects of this case is that Staff ignores the Commission's prior decisions to the same effect. In its decision in *GTE Corp. & Bell Atlantic Corp.* ("*GTE/Bell Atlantic*"), Ill. C.C. Docket No. 98-0866, 198 PUR 4th 193, 1999 Ill. PUC LEXIS 825, at *101 (Ill. CC, Oct. 29, 1999), the Commission stated that "to the extent that costs are incurred to produce savings and are shown to be both reasonable and directly related, netting [of acquisition costs against acquisition savings] is appropriate." *Id.*

The Acquisition Adjustment is a prudent investment resulting in reductions in the cost of service and, in this respect, is comparable to expenditures for such programs as employee termination payments, which are prudent expenses of operation incurred in order to generate future savings and are recoverable. *See, e.g.*, *Commonwealth Edison Co.*, Docket No. 94-0065, 1995 Ill. PUC LEXIS 25, at *85-91 (Jan. 9, 1995) (early retirement program costs allowed in rates); *Illinois Bell Telephone Co.*, Docket Nos. 92-0448 and 93-0238, 1994 Ill. PUC LEXIS 437, at *236 (Oct. 11, 1994) (severance and workforce resizing costs amortized and allowed in rates); *GTE North, Inc.*, Docket Nos. 93-0301 and 94-0041, 1994 Ill. PUC LEXIS 436, *56 (Oct. 11, 1994) (severance costs amortized and allowed in rates); *Illinois Power Co.*, Docket No. 89-0276, 1990 WL 488736, at *103-04 (June 6, 1990) (early retirement plan costs amortized and allowed in rates). Staff also ignores the myriad of cases demonstrating that it has been the policy of the Commission to allow rate recovery of costs incurred to produce operational savings and efficiencies by allowing amortization of such costs over a reasonable period.

**d. Reasonable Return to Shareholders**

Absent the opportunity for shareholders to recover their investment, there is no financial incentive for the Company to propose the transaction to generate the Savings in the first place.

[IAWC Ex. 8.0R, p. 5.] Staff has it backwards: rates would be higher, not lower, if no Acquisition takes place because the Commission refuses to offer an opportunity for cost recovery. [IAWC Ex. 2.0R, p. 14.] Mr. Mülle explained that certainly rates would be lower if an acquisition were to take place with all savings being passed on to customers and all costs incurred by shareholders -- all else remaining unchanged, but that this is no different from a suggestion that improper disallowance of any prudent cost would, as a matter of mathematics, produce a lower rate. Staff's approach, by not allowing IAWC an opportunity to recover the Acquisition Adjustment, would place IAWC in a financially impaired condition, as discussed by Messrs. Ruckman and Gloriod. Should the Acquisition not occur, economies would not materialize and there would be no Savings at all. This result would benefit no one. [IAWC Ex. 8.0R, p. 13.]

As Mr. Mülle explained, shareholders will balk at making otherwise desirable and economic combinations of operating properties, if there is a lack of incentive and they are required to bear the entire burden of the disposition of the Acquisition Adjustment. Investors are "risk averse," and require a return commensurate to the risk they are being asked to assume. A savings sharing arrangement is the best solution to reconciling the market required price levels of acquisitions with the original cost basis of regulation, but its parameters are closely defined by the anticipated savings and the cost of the acquisition. The SSP is just such a plan and, as Mr. Hartnett and Mr. Mülle indicate, one under which the price paid for the Acquisition is consistent with the savings to be received by shareholders and consumers alike. [IAWC Exs. 4.0R, pp. 4-5 (Hartnett); 8.0R, p. 4 (Mülle)]. As shown in IAWC Exhibit 3.6 R, of the $447,718,893 total savings projected over the next 40 years, the customers receive the first 10% of Demonstrated Savings each year, or approximately $44,771,889. The Acquisition Revenue Requirement is

$246,084,000, resulting in net available Savings of $201,634,893. In addition to the first 10% of available Savings, customers have the opportunity, under the SSP, to realize additional Savings in the amount of $92,464,758, bringing the total potential Savings for customers to $137,236,647 or 68% of the total available net savings. Provided that Savings are adequately demonstrated to exist in rate cases, the shareholders have the opportunity, under the SSP, to realize net Acquisition Savings of $64,398,246 or 32% of the amount available. Under the SSP, customers and shareholders each receive a reasonable portion of the available net savings. [IAWC Ex. 8.0R, pp. 4-5.] The Staff approach, under which recovery of the Acquisition Revenue Requirement would be denied, does not offer any financial incentive for the Company to proceed with the Acquisition. As IAWC Exhibit 3.6R indicates, the Staff proposal offers nothing but a 139% loss for the shareholders, and allocation of over two times net available savings (222%) to customers. That hardly makes any business sense. Staff's proposal amounts to nothing more than an unjustified confiscation of assets from shareholders and transfer of those assets to ratepayers. [*Id.*, p. 6.]

#### e. Conditions in the Water/Wastewater Industry

This Commission does not operate in a vacuum. It must adapt its policies to the current exigencies of the economy and of the various industries which it regulates. In this proceeding, Mr. Kelleher, Mr. Mülle and Mr. Townsley testified extensively with regard to the current state of the water utility industry, the driving forces behind the industry's need to consolidate and the advisability of adoption of a regulatory policy encouraging the consolidation and integration of fragmented water utility operations.

Mr. Kelleher testified that the water industry is the most capital intensive of all the traditional public utility sectors and that it faces huge capital investment costs to replace aging infrastructure and constantly increasing quality standards imposed by the USEPA pursuant to the

Safe Drinking Water Act. [IAWC Ex. 5.0, pp. 2-7.] In 1997, the USEPA estimated that the water industry's twenty-year infrastructure investment need was approximately $138 billion. A more recent estimation of the distribution system investment requirements by the American Water Works Association raised this estimation to $360 billion, and a report issued by the Water Infrastructure Network in March of 2000, estimated that total water and wastewater infrastructure investment requirements could approach $1 trillion over 20 years. It does not matter which of these estimates is more accurate. The point is that the investment requirements of the water and wastewater industry over the next 20 years for infrastructure replacement, water quality compliance and normal population growth are substantial. [IAWC Ex. 80.R, pp. 22-23.]

Also, as Mr. Kelleher testified, the industry is a rising cost industry because, in the face of rising costs and capital requirements, per capita customer water usage has remained static due to supply constraints, conservation and environmental ethics. Increased costs cannot, therefore, be offset by rising demand. As a result, the only feasible means for mitigating rate increases dictated by rising costs is the realization of cost reductions which result from synergies occasioned by consolidation and integration of what is now a fragmented industry. [IAWC Ex. 5.0, pp. 6-7.] Each of these cost, investment and usage factors affecting the water industry is applicable to IAWC. As Mr. Kelleher indicates (and as IAWC Exhibit 5.4 shows), IAWC's investment in net plant per customer has steadily increased in recent years, while usage per customer has slightly declined. While future usage per customer is expected to be relatively flat, AWW expects a continued increase in the level of plant investment per customer. Under these circumstances, it is not reasonable to expect that rate decreases will be possible. However, if the SSP is approved, Acquisition savings will be available to mitigate the level of rate increases which otherwise would be necessary. [IAWC Ex. 8.0R, p. 23.]

The Clean Water Act continues to impact the wastewater side of the business. For instance, regulatory initiatives in Illinois involving new measurement techniques, more stringent effluent ammonia limits, and a Total Maximum Daily Load ("TMDL") on an individual stream basis are among the items which may require significant additional capital investments. The demands for capital are increasing with the demand for higher quality. [Jt. App. Ex. 10, p. 6.] Mr. Townsley indicated that, by taking the position that Acquisition Adjustments should not be recoverable from savings generated by consolidation, Staff is ignoring these concerns. [Jt. App. Ex. 10, pp. 6-7.]

Mr. Townsley's testimony demonstrated that one of the principal benefits to ratepayers of consolidation is high quality water and wastewater service, because size and expertise are necessary to achieve that reality. He also testified that, from his perspective of involvement with the water industry, he could verify that AWW is the finest quality water provider in America and that Citizens' customers can only be well served by approval of the sale to an AWW subsidiary. [Jt. App. Ex. 10, p. 2.]

Mr. Townsley indicated his awareness of the problems of poor water quality, poor service, financial instability and operational weaknesses associated with small water companies. He indicated that small water companies mean large headaches for regulatory Commissions, and even larger problems for customers who live in their service areas, when they lack the expertise and financial resources required to provide safe and adequate service. [Jt. App. Ex. 10, p. 3.]

Mr. Townsley stated that the Acquisition before this Commission offers the opportunity for a water/wastewater utility to emerge which has the size to be an important option for this Commission when addressing the problems of small water or wastewater companies. Although CUCI has successfully absorbed some small and/or troubled utilities in the past, on a prospective basis, CUC has concluded that the existing and prospective needs of many small troubled water and wastewater utilities are too great and CUC cannot logically pursue this course any longer in Illinois or elsewhere. [Jt. App. Ex. 10, p. 3.] In contrast, AWW, strengthened by its acquisitions, would have the size in Illinois to have sufficient synergies to regularly absorb troubled water/wastewater systems with minimal impact on underlying operations. AWW has a demonstrated record of being the country's leader in absorbing smaller entities, where it has sufficient size to be the major player in the state. [*Id.*, p. 4.] The public interest is clearly served by creation of a sufficiently sized entity to which this Commission can turn to for professional, financially responsible intervention into troubled small water/wastewater companies. [*Id.*]

Both in this country and around the world, the water industry has recognized the need to achieve size and economies of scale. There is clearly recognition that, if safe and high quality water is to be provided for human consumption, entities of size are needed. Domestically, the same consolidation is occurring as in other parts of the world, as both the industry and regulators have recognized that increased environmental and health concerns can only be addressed by larger entities. [*Id.* at 4-5.]

Mr. Townsley agreed with Mr. Kelleher that the water/wastewater industry is the most capital intensive of the regulated industries and stated that, in his experience, larger water and wastewater corporate entities have lower cost debt and easier access to required debt capital. [*Id.* at 5.]

Mr. Townsley took issue with Staff witness Roy King's testimony (ICC Staff Ex. 6.0, p. 5) that CUCI would be able to provide adequate, reliable, efficient and safe service to Illinois customers if the asset sales are approved in all other states and this Commission refuses to approve the Application herein. In fact, because of the concerns outlined above, CUC is no longer willing to be in the water and wastewater businesses. He stated that AWW can address new proposed standards in the water and wastewater business more effectively and cheaply than CUCI because AWW has the expertise to be a far more effective implementer of change and further has the ability to achieve economies of scale. The costs of ubiquitous compliance tasks performed for a larger base of customers by an in-house team of experts would result in a reduced incremental cost. Mr. Townsley also pointed to AWW's nationally-recognized research facilities located in Illinois. [Jt. App. Ex. 10, pp. 7-8.]

Mr. Townsley indicated that, if we as a nation are truly serious about the importance of water quality to our own health and that of our families, we must permit the creation of entities that have as their primary business the provision of quality water and wastewater service. If we are going to achieve that quality at a price level that is tolerable, an entity with the size and expertise to do the job is needed. As Messrs. Kelleher, Mülle and Townsley indicated, permitting the recovery of acquisition adjustments resulting from the need to pay acquisition premiums is the *sine qua non* of a policy encouraging the needed consolidation. [IAWC Ex. 5.0R, pp. 15-16 (Kelleher); IAWC Ex. 8.0R, pp. 4-5 (Mülle), 13; Jt. App. Ex. 10, pp. 11-12 (Townsley).]

Mr. King maintained that, due to the service standards specified in Sections of the Illinois Public Utilities Act (*e.g.*, §§ 8-101 and 8-104; Tr. 722-725) and Rules of the Commission (*e.g.*, 83 Illinois Administrative Code, Part 600; Tr. 725), the Commission need not be concerned about the possibility that service to customers would decline in the event that CUCI continued to operate on a stand-alone basis. [Tr. 722-723] Mr. King acknowledged, however, that, on past occasions with which he was familiar, customers and the Commission had experienced significant problems when utilities subject to these same statutes and regulations failed to provide service in accordance with their terms. [Tr. 726-729.] As Mr. King acknowledged, the existence of statutory provisions and rules do not guarantee that adequate service will be provided. [Tr. 725, 729.] Mr. King notes that, in the past, concerns with regard to the adequacy of service have arisen with regard to both small and large utilities, and that he conducted no study or analysis for purposes of this case. [Tr. 722, 725; 729-30.]

Mr. Townsley also responded to Staff witness David Borden's testimony (ICC Staff Ex. 5.0, p. 7) which appears to indicate that benefits from the proposed transaction do not justify the recovery of the Acquisition Adjustment from customers. Mr. Townsley indicated that, beyond the synergy savings which can be realized, Mr. Borden is ignoring the fact that AWW will be able to provide the CUCI Illinois operations with the investment and expertise needed to meet infrastructure replacement needs and new regulatory requirements facing the industry, which CUCI itself will not be able to provide because it will become increasingly difficult to do so for medium-sized water/wastewater companies like CUCI. [Jt. App. Ex. 10, pp. 11-12.]

### 2. Staff's Position That An Opportunity To Recover the Acquisition Adjustment Should be Denied is Without Merit

In its evidence, Staff, in large part, fails to address the policy issues raised by Illinois-American. Instead, Staff offers a series of arguments that turn mathematics on its head, erroneously contend that the Company's proposal violates ratemaking and accounting principles and, in general, confuse the issues. In this Section, the Company responds to Staff's positions.

#### a. There Will Be No Adverse Effect On Customer Rates If The Company's Savings Sharing Proposal is Approved; Customers Will Receive Significant Benefits

Mr. Smith contends that the purchase of the Utility Assets by Illinois-American will have a negative rate consequence for the customers. Specifically, Mr. Smith contends that, if the excess of purchase price above original cost of the acquired Utility Assets is included in revenue requirement, the customer's financial obligation to the serving water and wastewater utility will be greater than if the Acquisition Premium is excluded. [ICC Staff Ex. 1.0, p. 14.] Mr. Smith's adverse rate consequence contention rests on the wrong comparison. The right comparison is between rates under the Acquisition and SSP, on the one hand, and rates without the Acquisition, on the other, not the comparison which Mr. Smith makes in his Staff Exhibit 7.0, Schedule 1, where he compares the new revenue requirement resulting from the Acquisition and SSP to the new cost of service after Acquisition-related savings have already been realized. [IAWC Ex. 9.0SR, pp. 7-9.] It is uncontested that, under the proper comparison, rates to customers will be lower if the Acquisition and SSP are both approved. [*Id.* at 9.] Mr. Smith's comparison is akin to his arguing with respect to an offered discount on a product he wishes to purchase that the discount has an adverse consequence on him, because he would be better off if he did not have to pay for the product at all.

As Mr. Ruckman explained, lines 1-7 of Schedule 1 fail to consider the reduction to the Total Operating Cost of Service that will result from the proposed Reorganization. In addition, page 2 of Mr. Smith's Schedule 1 does not take into account the assignment to shareholders of the amount by which Acquisition Revenue Requirement exceeds savings. A corrected representation of Mr. Smith's Schedule appears as IAWC Exhibit 2.4SR. Contrary to Mr. Smith's testimony, Exhibit 2.4SR clearly demonstrates that savings will be used to reduce revenue requirement. Without question, customers will benefit from the Company's proposal. [IAWC Ex. 2.0SR, p. 3.]

As Mr. Flaherty, Mr. Gloriod and Mr. Ruckman discussed, the SSP can have no adverse impact on rates at any time. In rate orders issued for the combined Company, ratepayers would be assigned at least ten percent (10%) of the Demonstrated Savings. Recovery of the Acquisition

Revenue Requirement would be allowed under the SSP only to the extent of ninety percent (90%) of the Demonstrated Savings. Mr. Stafford gave an example which illustrates the impact of the Acquisition and SSP: if a monthly water bill prior to the Acquisition is $30 per customer and Acquisition-related savings are $10 per customer per month, the customer will realize a $1 reduction in his monthly bill (10% of savings). Consequently, the customer's bill, all else being equal, would be $29. The other $9 of savings will go to paying the Acquisition Adjustment, but the customer's bill is still lower than it would have been without the Acquisition. [Tr. 600-01.]

IAWC's proposal would clearly provide customers with lower costs and better service, all at no risk to the customer. [IAWC Ex. 2.0R, pp. 7-8.] Furthermore, shareholders recover a portion of the Acquisition Revenue Requirement only to the extent that the level of Demonstrated Savings is adequate to cover the Acquisition Revenue Requirement. If there are no Acquisition Savings at all (an extremely unlikely scenario), rates would remain at the stand-alone level, with no possibility under the SSP that rates could increase as a result of the Acquisition. [*Id.*, p. 9.]

Mr. Borden and Mr. Gorman argue that, if the Acquisition were to proceed with approval of the SSP, rates could increase to reflect the increased cost of capital which would result if the Company's financial condition is impaired as the result of its inability to demonstrate that in future rate cases that an amount of Savings adequate to cover the Acquisition Revenue Requirement exists. As Mr. Ruckman and Mr. Flaherty explained, however, the Company has made a commitment that, if the SSP is approved, it will not propose to reflect in rates any incremental increase in the cost of capital which relates to a future inability to demonstrate an adequate level of savings. [Tr. 636 (Ruckman); IAWC Ex. 9.0SR, p. 11 (Flaherty).]

In another variant on the same theme, Mr. Smith contends that the SSP would result in something other than least-cost operations. [ICC Staff Ex. 1.0, p. 14.] As Mr. Ruckman explained, it is the Company's proposal that reduces cost of service to the customers. Mr. Smith would cause them to pay higher rates. Accordingly, there is no basis for Mr. Smith's contention that the Company will be providing something other than least-cost service. [IAWC Ex. 2.0R, p. 8.]

This exercise in specious reasoning goes on with Mr. Smith's contention that the SSP allows for the development of a revenue requirement which exceeds the cost of operating the utility system and thus will have a negative rate impact on customers, [ICC Staff Ex. 1.0, p. 15.] and Mr. Borden's contention that the Company's proposal results in rates greater than their just and reasonable levels and thus will have an adverse rate impact on retail customers. [ICC Staff Ex. 5.0, p. 4.] The same answer applies: They are making the wrong comparison. As Mr. Mülle explained, under the SSP, there can be no adverse impact on the customer. The first allocation of net savings is to the customers. The potential return of <u>some</u> of the Savings to the investors is necessary to cover the Acquisition Revenue Requirement and make the transaction feasible from a financial standpoint. [IAWC Ex. 8.0R, p. 13.]

Addressing Messrs. Gorman's and Borden's concerns regarding increased costs to customers, Mr. Flaherty explained that the existence of the Acquisition Revenue Requirement does not increase costs to customers. For any Savings to be realized by customers, this transaction has to be completed. The comparison more appropriately is whether customers are better off in the absence of this transaction. The answer here is clearly not. Messrs. Gorman and Borden would forego any benefit to customers in the hope of trying to capture all possible Savings. [IAWC Ex. 9.0R, pp. 19-20.]

Mr. Flaherty summarized the benefits the SSP will have on customers, noting that it transfers the risk of savings realization to the shareholders while still providing benefits to customers. Under the SSP, customers receive the benefit of 10% of the savings and all operational enhancements while the company is at risk for the recovery of the Acquisition Premium through the production of Demonstrated Savings. If the Company achieves no Savings, the shareholders bear the entire cost of the Acquisition Revenue Requirement. However, if the Company achieves Savings in excess of the Acquisition Premium, the customers share substantially in those Savings through the 50% allocation mechanism. Moreover, after the 40-year SSP period, and for every year thereafter, customers will receive 100% of all Savings, which substantially increases total benefits. [*Id.*, p. 21.]

**b. Acquisition Adjustment Is Not A Transaction Cost**

Mr. Smith contends that the Acquisition Adjustment is a transaction cost of the type deemed non-recoverable in Dockets 98-0555 and 98-0866. [ICC Staff Ex. 1.0, p. 4.] As Mr. Ruckman explained, however, the Acquisition Adjustment is an asset recorded on the balance sheet. It is a part of the price paid to the Seller for the assets acquired, a direct cost of the Acquisition. [IAWC Ex. 2.0R, pp. 2-3.]

As Mr. Hamilton indicated, transaction costs do not include the direct investment required by a transaction, including any premium above book value, but rather are the procedural expenses of effectuating an acquisition. Transaction costs are equivalent to the **expenses** described in Paragraph 76, Costs of Acquisition, of Accounting Principles Board Opinion No. 16 entitled Business Combinations. Paragraph 76 of APB 16 states:

> 76. *Costs of acquisition*. The cost of a company acquired in a business combination accounted for by the purchase method includes the direct costs of acquisition. .... However, indirect and general expenses related to acquisitions are deducted as incurred in determining net income.

Transaction costs are the indirect, and general expenses of acquiring the asset or stock. Indirect and general expenses are deducted currently for financial statement purposes and the direct costs of the acquisition are capitalized and amortized over an appropriate period. [IAWC Ex. 7.0R, pp. 6-7.]

In addition, the National Association of Regulatory Utility Commissioners 1996 Uniform System of Accounts for Class A Water Utilities (the "Uniform System of Accounts" or "USOA") directly addresses this issue and clearly does not consider the asset acquisition premium as a "transaction cost." The discussion of Account 114, Utility Plant Acquisition Adjustment, paragraph A states:

> [T]his account shall include the difference between (a) the cost of the accounting utility of utility plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and (b) the original cost, estimated, if not known, of such property, less the amount or amounts credited by the accounting utility at the time of acquisition to accumulated depreciation, accumulated amortization and contribution in aid of construction with respect to such property.

Illinois-American proposes to properly record the plant Acquisition Adjustment in accordance with the requirements of Account 114 of the Uniform System of Accounts. Thus, it is not appropriate to classify the premium (plant Acquisition Adjustment) that Illinois-American is paying for the Utility Assets as a "transaction cost." [IAWC Ex. 7.0R, pp. 7-8.]

In the same vein, Mr. Borden states that "by allowing the Company to recover the acquisition adjustment from ratepayers through the mechanics of the Company's Savings Sharing Proposal ratepayers will subsidize a transaction cost of the merger through utility funds." [ICC Staff Ex. 5.0, pp. 3-4.] As Mr. Mülle explained, the Acquisition Adjustment is the collective difference in the value of the assets (i) as formerly carried on the books of the former utility owner at their net original cost <u>when first devoted to public service</u>; and (ii) the purchase price (fair market value) of the assets purchased by the utility now owning those assets. Transaction costs are not assets. Transaction costs are acquiring expenses incurred in executing the transaction and transferring ownership of the assets. The Acquisition Adjustment, on the other hand, is the premium over net book value that the Company is required to provide up front as an investment, in return for the expectation of synergies and Savings to come. The ratepayers share in the anticipated Savings, while assuming no risk at all. The Acquisition costs them nothing "up front" in the form of transaction (or any other cost) and nothing later on. The Acquisition, however, provides for ratepayers monetary Savings and significant non-monetary benefits discussed by Mr. Kelleher, which they would not have otherwise experienced nor expected. [IAWC Ex. 8.0R, p. 7.]

As a result of Mr. Borden's misunderstanding regarding transaction costs, he concludes that the SSP should be rejected because of his belief that it would result in subsidization of non-utility activities. [ICC Staff Ex. 5.0, p. 2.] As Mr. Mülle further explained, Mr. Borden draws this conclusion because he repeatedly confuses the Acquisition Adjustment (a collection of asset values) with a "transaction cost." The Uniform System of Accounts, as reported in *Water Utility Accounting*, Third Edition, American Water Works Association, 1995, p. 124, however, specifically defines the Utility Plant Acquisition Adjustment (Account 114) in the manner quoted above with reference to the position of Staff witness Smith. Utility Plant Acquisition Adjustments Account (114) and Other Utility Plant Adjustments Account (116) contain all plant amounts of the accounting company (Acquirer) that exceed net original cost (*Public Utility Economics*, Garfield and Lovejoy, Prentice-Hall, 1964, Pp. 86-94). As Mr. Mülle indicated, there are no items of "transaction costs" included in these plant accounts. [IAWC Ex. 8.0R,

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p. 8.] In this regard, Mr. Mülle's testimony confirms that of Mr. Hamilton discussed above (IAWC Ex. 7.0R, pp. 7-8).

### c. Accounting Principles Will Not Be Violated

Mr. Smith also states that there are no discernable accounting or ratemaking principles which support the Company's proposal. [ICC Staff Ex. 1.0, p. 4; ICC Staff Ex. 7.0, p. 2.] Savings, however, are simply negative costs, i.e., cost levels are lower because of Savings. This is not a matter of complex accounting principles. Under the SSP, after the initial allocation of Savings to ratepayers, the remaining 90% of Savings would be assigned to cover the Acquisition Premium Revenue Requirement. If Savings remain, such Savings would flow equally to customers and shareholders. To accomplish these results, a separate adjustment category, identified as "contra costs", can be established, i.e., a negative cost add-back can be derived to assure that the shareholder portion of the Savings is recognized. [IAWC Ex. 9.0 R, p. 31.]

Furthermore, as Mr. Hamilton explained, the Uniform System of Accounts provides the necessary accounts to properly record both the SSP and the amortization of the Acquisition Adjustment above the line. Specifically, in the Uniform System of Accounts, Item C to the description of Account 114, entitled *Utility Plant Acquisition Adjustments,* states, "[t]he amounts recorded in this account with respect to each property acquisition shall be amortized, or otherwise disposed of, as the Commission may approve or direct." The ICC has discretion to direct how the amortization of the plant Acquisition Adjustment arising from the premium paid for the Utility Assets is recorded. If the ICC permits the recording of this amortization above the line (e.g. Account 406, *Amortization of Utility Plant Acquisition Adjustments* provides for this upon approval of the ICC) to the extent of Savings directly resulting from the Acquisition, then that would be the acceptable method for both ratemaking and financial reporting purposes. As Mr. Hamilton explained, the ICC has wide latitude in directing how costs are recorded, and the

Uniform System of Accounts permits the accounting proposed by Illinois-American. [IAWC Ex. 7.0R, p.14.]

As Mr. Ruckman explained, under the SSP, Acquisition Costs would be recorded above-the-line to the extent that Demonstrated Savings are allocated at the time of a rate case to cover Acquisition Costs. As noted above, Mr. Hamilton identified the accounts in the USOA in which Acquisition Costs should be recorded. Moreover Mr. Smith acknowledged that, even under his characterization of the Acquisition Costs, such costs are recordable under the USOA in above-the-line accounts. As noted above, Mr. Smith characterizes the Acquisition Premium as a transaction cost comparable to the merger fees and expenses referenced in Dockets 98-0555 and 98-0866. [Tr. 824.] As he acknowledged, such fees and expenses are recordable under the USOA in Account 301, a rate base account. [Tr. 820.] If, as Illinois-American maintains, the Acquisition Premium is viewed as an "asset," and not a "cost," Mr. Smith was still able to identify applicable USOA accounts. As he testified, an Acquisition Premium is recorded under Account 114 of the USOA, which indicates expressly that the Commission has discretion to determine the manner in which the Premium should be disposed of. [Tr. 818-19.] Mr. Smith admitted that, under the USOA, the Commission has the authority to permit the recovery of an Acquisition Premium. [Tr. 821.] Moreover, Mr. Smith acknowledged that, if above-the-line disposition of the Premium is authorized, the amortization should be recorded in Account 406, the same account referenced by Mr. Hamilton. [Tr. 824.] Thus, Mr. Smith's assertion that accounting principles do not support the Company's proposal to recover Acquisition Costs under the SSP is inconsistent with his own testimony.

**d. Sharing of Savings And Obligation of the Company**

Mr. Smith argues that it does not make sense for Illinois-American to include recovery of the Acquisition Adjustment, or Savings, in revenue requirement because efficient management is an obligation of utilities. [ICC Staff Ex. 1.0, p. 8.] As Mr. Kelleher explained, Mr. Smith's reasoning is flawed in that a decision to combine two companies is not an obligation of either utility. Mr. Smith is confusing the obligation of a utility to manage and operate its going concern on a least cost basis with the facts in this case involving a consolidation of two well-operated water utilities into a less-expensive-to-operate (on a per customer basis) utility. By making the investment to acquire the Utility Assets, which Illinois-American is not obligated to do, Illinois-American, at a substantial investment cost, generates immediate and quantifiable benefits which customers receive. [IAWC Ex. 5.0R, pp. 12-13.] As this and other regulatory commissions have recognized, in order to provide an appropriate incentive for utility investments, it is essential that shareholders be given an opportunity to recover the value of assets devoted to utility service. This same principle applies, whether the investment is in new facilities or used facilities, as long as there are resulting customer benefits to be realized. [IAWC Ex. 2.0R, p. 3.]

Mr. Smith then concludes that "given Illinois-American's argument that it should be entitled to include savings in revenue requirement, it could be reasonable to increase revenue requirements of low-cost utilities above the actual cost, so that shareholders share in savings which result from efficient operations." [ICC Staff Ex. 1.0, p. 7.] Mr. Gloriod explained that Mr. Smith's testimony demonstrates a misunderstanding of IAWC's proposal. It cannot be disputed that Illinois-American will incur investment costs if the Acquisition is consummated. IAWC is not asking that the Acquisition Revenue Requirement be increased "above" actual cost. IAWC has proposed instead that the Acquisition Revenue Requirement be adjusted to include Acquisition Costs, but only to the extent that there are Demonstrated Savings. Costs that give rise to efficiencies and savings are routinely included in the revenue requirement. *Commonwealth Edison*, Docket 94-0065, 158 PUR 4th 458 (Ill. CC, Jan. 9, 1995)(e.g., workforce reduction-severance costs); *Consumer Illinois Water Company*, Docket 97-0351, 1998 Ill. PUC LEXIS 447 (Ill. CC, June 3, 1998) (costs for employee training regarding efficiency and incentive compensation program designed to produce savings allowed in rates). There is no basis to treat Acquisition Costs in a different manner. If Acquisition Costs are prudently incurred for the benefit of ratepayers, such costs should be recoverable in rates; especially where the recovery is limited to the amount of Demonstrated Savings. [IAWC Ex. 1.0R, p. 3.]

### e. Acquisition Savings Include Only Savings Resulting From The Acquisition

Staff and IIWC have expressed concern that some portion of the Savings identified by IAWC, particularly in the area of staffing and cost of capital, may not really be acquisition related. For example, Mr. Smith makes the unsupported statement that there is no causal relationship between Acquisition Costs and Savings. [ICC Staff Ex. 1.0, p. 14.] Mr. Ruckman addressed this assertion, noting that Mr. Smith ignores the fact that, as defined in the SSP, Demonstrated Savings include only those Savings which are shown to be related to the Acquisition and which are actually demonstrated to exist in future rate cases. Because the Acquisition Adjustment was incurred to make the Acquisition possible and the Acquisition Savings would not result in absence of the Acquisition, it follows that there is a direct causal relationship between the Acquisition Adjustment and the Acquisition Savings which result from combining the two stand alone operating utilities into a single organization, thus allowing for the elimination of redundant positions and other economies of scale. [IAWC Ex. 2.0R, p. 7.]

Mr. Flaherty also addressed this concern: he reviewed the nature of IAWC's Savings and explained that his review indicates that the Savings are typical of those produced in other merger and acquisition transactions, and similar to those he is personally familiar with from other water company transactions, as well as other electric, gas, and telecommunications transactions.

[IAWC Ex. 9.0R, p. 9.] Mr. Flaherty further testified that whether a Savings is "acquisition related," depends on whether the Savings could be derived absent the transaction, e.g., through best practice adoption or management self-action. Thus, an "event", i.e., a reduced cost level, would qualify as Acquisition related if it would not exist "but for" the existence of the transaction. As Mr. Flaherty explained, the Savings in this case are Acquisition-related and not otherwise available. For example, reduced staffing levels typically occur in every consolidation, particularly where there are significant scale differences between the companies or there is close geographic proximity that would leverage opportunities to eliminate duplication. [*Id.*, pp. 9-10.] Mr. Flaherty further explained that Staff and IIWC do not have valid concerns regarding whether the identified Savings are "acquisition related." In fact, the absence of any specific discussion of identified issues is striking. In the case of Mr. Gorman, he simply asserts that "it is not clear that the employee reduction could not be achieved absent the acquisition." No support is provided for this assertion at all, notwithstanding the level of detail provided by IAWC in support of quantification. [*Id.*, p. 10.] Similarly, Ms. Everson's comments that these expense reductions could be for an entirely different reason, such as technological advances, is totally unsupported. [*Id.*, p. 10.]

Mr. Smith and Ms. Everson suggest that Savings initially resulting from the Acquisition may, during the amortization period, be overtaken by technological innovations which would create the Savings anyway *(e.g.* elimination of a position), regardless of the Acquisition. [ICC Staff Ex. 1.0, pp. 5-6, ICC Staff Ex. 2.0, p. 6.] As Mr. Ruckman explained, none of the Savings identified by the Company are based initially on technological changes. Moreover, subsequent to the Reorganization, if technological changes occur which would duplicate savings already realized by virtue of elimination of duplication as a result of the Acquisition, that portion of the

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Acquisition Savings would no longer qualify as Acquisition Savings or Demonstrated Savings as those terms are used in the Savings Sharing Proposal and would be eliminated from the equation. Acquisition Savings will include only those savings which result, and continue to result, from the Acquisition. Savings which result from a technological change would not be included in "Acquisition Savings," nor "Demonstrated Savings", and thus would not be used as a basis to allocate the Acquisition Revenue Requirement under the Savings Sharing Proposal. The burden will rest with IAWC in future rate cases to demonstrate that the Savings under consideration initially result from, and continue to result from, the Acquisition. [IAWC Ex. 2.0R, p. 4.]

As Mr. Flaherty explained, once savings events occur, the resulting Savings are easy to account for and reflect in future periods. Most transactions that accountants capture occur in a continuous stream of discreet events. Acquisition Savings, on the other hand, result from a finite set of events that, once captured, can be carried forward from period to period. This process is straightforward and can be implemented without complexity. [IAWC Ex. 9.0SR, p. 15.]

While it is true that the use of some assumptions is necessary to extend the stand-alone costs, and therefore the net Savings forward, these assumptions will be reviewed periodically by the Commission to ensure that the assumptions remain valid. That review can be conducted with the benefit of actual information concerning cost levels, technology, and other exogenous factors which have occurred since the last Commission review. Once a savings event has been identified, a later review would focus in most cases on the change in the level of Savings from the time of the prior review. This is easily accomplished using available data regarding Company cost levels and publicly available information. [IAWC Ex. 9.0SR, pp. 15-16.]

Staff witnesses suggest that, because Citizens would no longer exist as a stand-alone entity, it would be impossible to estimate what its costs would be. [ICC Staff Ex. 7.0, p. 15].

The cost assumptions of Citizens as a stand-alone company subsequent to the Acquisition, however, can be reliably quantified through the use of traditional techniques. These types of forecasts are not new in ratemaking, and continue to be utilized. Commissions often use forecasting, trending, and other techniques to make reasonable estimates of future costs. The net salvage value calculation used in setting depreciation rates is one example. [IAWC Ex. 9.0SR, p. 16.]

The Company has proposed that actual Savings be specifically determined in future rate proceedings. This can be done by using the data underlying the current cost structure for the stand-alone ownership structure of Citizens as a baseline for future comparison. Actual costs will be verifiable in each of these future periods through traditional methods. The baseline costs can be determined by using the current stand-alone cost structure and the difference will generally be the result of the savings "events" that arise from the acquisition, and can be identified and evaluated individually. Verification of these figures can occur during the normal course of each ratemaking process. The continued use of savings sharing plans by many ratemaking authorities demonstrates that such plans are workable over short and long-term time frames and are not beyond the capacity of all parties to deal with. [IAWC Ex. 9.0SR, pp. 16-17.]

It is also misleading to assert that the 40-year time frame creates an insurmountable obstacle to measurement. In reality, the measurement period is between each rate case with only those changes occurring between these dates being relevant. As discussed above, once the baseline is established and the savings event occurs, it is primarily the change in the amount of savings which must be determined from case to case. Review of the potential effects of exogenous factors also is necessary at each rate case. However, a belief that a water utility